17th July 2009

Inquiry into Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

Hay Group Submission to the Senate Economics References Committee

HayGroup

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Introduction

Thank you for the opportunity to provide this submission to the Senate's inquiry into the Corporations Amendment (Improving Accountability on Termination Payments) Bill.

Hay Group supports a review of termination payment practices as an integrated component of executive employment arrangements. However, we urge careful consideration of the proposed amendments with respect to:

- likely unintended consequences; and
- potential lack of alignment with possible outcomes of the Productivity Commission's current comprehensive review of executive reward.

Taking into account the Australian market context and having provided executive reward services to numerous organisations globally and in Australia over many years, Hay Group:

- cautions against regulatory intervention as a means of controlling executive reward practices as it could, even with well meaning intent, lead to unforeseen and unhelpful consequences such as increasing other forms of remuneration;
- asserts that executive reward (including termination payment) is a strategic business tool which, if effectively designed and implemented, can promote behaviour and results that are aligned with the interests of key stakeholders; and
- notes that, while there have been exceptions, executive reward design and application in the Australian market is generally well managed by boards, aligned with stakeholder interests and appropriately responsive to broader community sentiment.

About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organise people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organisations realise their potential. We have over 2500 employees working in 86 offices in 47 countries.

Locally, we operate out of seven offices across Australia and New Zealand with over 100 employees. We consult to listed, private and public sector organisations as well as the not-for-profit sector.

In Australia, our remuneration information is used by many of the top ASX listed organisations and we also advise Boards and management on director, executive and management remuneration.

Our submission covers the following related to the Government's reforms announced in March 2009:

- Trends in termination payments;
- Role of the Board;
- Purpose of termination payments;
- Limiting termination payments and implications of currently drafted amendment;
- Specific aspects of drafted amendments.

The information and views in this submission are current at time of submission. Our views have been informed by legislation and regulation (including those in draft form) current at the time of submission and need to be considered in the current regulatory context.

Trends in termination payments

There has been much commentary in relation to termination payments in recent times. The stated rationale for proposed reforms is to curb excessive termination benefits paid to executives. It is important to acknowledge that there has been a progressive downward trend towards contracted termination payments of between 10 and 15 months fixed annual reward over the last five years.

There have been a few of high profile exceptions to the downward trend, but in the main Australian Boards have effectively responded to evolving shareholder expectations that excessive termination payments be curtailed.

Termination payment changes over the last five years are set out in the following table. It should be noted there are 3 main forms of termination payments:

- contracted payments;
- crystallisation of incentive payments; and,
- payout of statutory entitlements.

This analysis includes the contracted termination amount only.

		2003		2008	
Reason for termination	***Months of fixed pay***	CEO	SE	CEO	SE
Bona Fide Redundancy	Less than 3 months	0%	0%	0 %	0%
	Between 3-9 months	0%	18%	20%	20%
	Between 10-15 months	36%	73%	60%	60%
	Between 16-21 months	28%	0%	10%	20%
	Between 22-27 months	18%	9%	10%	0%
	Greater than 27 months	12%	0%		
Other	Less than 3 months	10%	10%	0%	0%
	Between 3-9 months	0%	0%	27%	45%
	Between 10-15 months	20%	70%	73%	55%
	Between 16-21 months	30%	10%	0%	0%
	Between 22-27 months	20%	10%	0%	0%
	Greater than 27 months	20%	0%		

CEO = Chief Executive
SE = Senior Executive

Purpose of termination payments

As a key component of executive reward arrangements, termination payments serve a number of legitimate purposes.

- They are a legitimate part of the employment offer to executives, and Boards seeking to attract key talent into critical roles could be significantly disadvantaged if this element of executive compensation is diluted, through legislation. This is especially true of potential overseas executive employees who are being recruited into key roles in Australia and/or executives transferring residence within Australia.
- In cases where the employment contract is broken, through no fault of the employee, the termination payment represents a payment for breaking of the contract.
- They serve as risk mitigation for executive employees who take longer than other employees to find alternative employment given the relative scarcity of executive roles.

Role of the Board

Board members are expected to exercise their informed judgement, within legal and moral parameters, in the best interests of shareholders. They have a central role to play in balancing competing interests and determining appropriate executive reward arrangements.

In most instances, including containment of termination payment excess, answerability through “comply or explain” mechanisms is preferable to legislative control. It is our observation that the majority of Boards are mindful of the concerns of shareholders and treat the existing non-binding vote mechanism seriously. Overly prescriptive regulation can result in Board compliance irrespective of whether it is in the interests of that business, its shareholders or the broader community.

Limiting termination payments and implications of currently drafted amendment

As illustrated above, contracted termination amounts have been steadily decreasing over the last five years. This is due to:

- greater transparency of executive reward arrangements;
- increased shareholder awareness;
- the gravitas brought to bear on executive reward by the non-binding vote on the overall Remuneration Report; and
- ultimately Boards doing their job by effectively responding to evolving shareholder and society expectations.

A majority of organisations have reduced contracted termination payment amounts and, in our experience, boards of Australian companies deliberate extensively over executive reward decisions in order to ensure balanced and appropriate outcomes.

Notwithstanding these facts, Hay Group acknowledges that the pre-existing limit of seven times total salary, averaged over the previous three years of employment, is high and could potentially result in isolated cases of payments which may not be in shareholders' interests.

However, the current limitation of one year base salary is overly restrictive and potentially places Australian organisations at a disadvantage when competing for scarce international and/ or local talent.

Without access to this negotiating element, it is likely that Boards will be disadvantaged in their quest to attract the best possible talent and that executives will seek sign-on payments or increased fixed or at –risk remuneration components to compensate for a one year base salary limitation placed on termination payment, which is more restrictive than other OECD countries including the US, Canada and key nations in the Eurozone.

It is Hay Group's view that the intention to curb isolated cases of excessive termination payment would be better served through the establishment of clear guidelines and assigning accountability for boards to explain non-compliance to shareholders.

Within the context of this preferred position, we additionally provide the following comments on specific aspects of the drafted amendments.

Definition of base and inclusions in termination payment

Due to Australia's relatively sophisticated reward packaging practices, the use of a multiple of base salary to calculate termination payment limitation is inappropriate. Any employee for example, paying for a packaged vehicle or making additional personal contributions to superannuation, would be unfairly disadvantaged under such an arrangement. Fixed Annual Reward (FAR) includes the value of packaged or salary-sacrifice items and is the more appropriate reward element to consider.

Additionally, one proposed definition is to include statutory entitlements such as accrued leave in the total cap of one year base salary equivalent. These are previously earned entitlements and should be excluded.

Types of Termination and Statutory Entitlements

There are various types of termination including:

- Termination with or without cause;
- Retirement, whether at normal retirement date, early or late or due to ill-health;
- Death or permanent disability in service; or
- Genuine redundancy.

As drafted, the amendments make no distinction between termination types. Hay Group is of the view that different termination types may well warrant different payment treatments in specific instances.

Averaging

The proposed averaging of pay places those with relatively short service at the greatest disadvantage. Executive employees recently appointed or promoted would be most penalised for the relatively short time they have occupied their current roles.

Interestingly, for those who have been in roles for a number of years, the averaging methodology will invariably result in a maximum payment which is less than current base salary. In effect, this also penalises employees for the relative longer period and loyalty they have shown in occupying their roles.

Basing maximum termination payment on a multiple of current fixed annual remuneration, regardless of length of tenure, would be a simpler and more appropriate method.

The timing of the payments and shareholder vote

Under the currently drafted amendment the first available opportunity to ask shareholders to vote on any termination amount, above one year's base salary or prorated lower maximum due to short time in role, could be up to a year after the termination date. Such a delay in seeking approval for bona fide additional payments seems unreasonable but unavoidable under the current amendment.

Definition of persons covered by the legislation

We note that there are potential very real practical problems with the definition of the coverage of directors in private companies and subsidiaries of listed companies. The outcome of such coverage is that directors in relatively small subsidiary companies, including those in foreign countries, would potentially have their termination payments subject to shareholder voting where their salaries may in fact be relatively small and not significant in terms of relativities to other executives.

In Summary

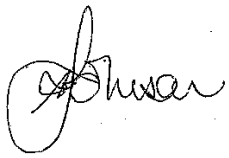
To reiterate, an overwhelming majority of Boards are extremely attentive to the concerns of shareholders and treat the existing non-binding vote on the overall Remuneration Report seriously. It is Hay Group's view that the establishment of clear guidelines intended to curb isolated cases of excessive termination payment, with accompanying "comply or explain" mechanisms, are preferable to the drafted hard law solution in this Corporations Amendment Bill which is likely to have unintended consequences for Board accountability and directors' ability to exercise their duties in the interests of shareholders. Our concern would be that the existing ambiguities with the legislation coupled with the demand to attract talent are likely to result in 'work-arounds' that deliver legitimate reward through other mechanisms.

In the interests of alignment and coherence on the complex interconnected issues related to executive reward, it might also be advantageous to delay passing this Bill until the findings of the Productivity Commission review are made available.

Contact

Trevor Warden
Executive Reward Practice Leader
Level 27
360 Collins Street
Melbourne 3000
Phone 03 9667 2628
trevor_warden@haygroup.com

Submitted by



Karyn Johnson
State Manager - Victoria

On behalf of Hay Group